(18)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 665

H. F. METCALF, as Trustee in Bankruptcy of the Estate of F. P. NEWPORT CORPORATION, LTD., a corporation, Bankrupt,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

To the Honorable Supreme Court of the United States:

H. F. Metcalf, as Trustee in Bankruptcy of F. P. Newport Corporation, Ltd., a corporation, Bankrupt, petitioner, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered November 23, 1942 [R. 211], reversing decision of the District Court of the United States, Southern District of California, Central Division. [R. 188-199.]

Statement.

F. P. Newport Corporation, Ltd., was adjudicated a bankrupt on January 12, 1937. Petitioner was appointed Trustee on March 18, 1937, duly qualified as such Trustee and took possession of all the assets and properties of the bankrupt corporation, and as such Trustee during the years 1938 and 1939 engaged in the transactions hereinafter mentioned.

On July 22, 1940, Nat Rogan, as United States Collector of Internal Revenue for the Sixth Collection District of California, filed a claim in the bankruptcy proceedings, on behalf of the United States, for the sum of $19,363.65, asserting thereby that said sum was payable by the petitioner as income taxes for the years 1938 and 1939, respectively. Objections to said claim were filed by petitioner, and a hearing thereon was had before the Referee in Bankruptcy to whom said proceeding had been referred by the District Court. These objections were sustained by the Referee, and the claim so filed by the Collector was disallowed. The Government took a review to the District Court, and the District Court on the 17th day of December, 1941, entered its order approving and affirming the Referee's order so disallowing said claim. An appeal from said order was taken by the Government to the United States Circuit Court of Appeals for the Ninth Circuit, and the latter court filed and entered its judgment on November 23, 1942, reversing said order of the District Court.

The bankrupt corporation was organized under the laws of the State of Delaware on December 2, 1929. Shortly thereafter it qualified to do business in the State of California, and thereupon entered upon and engaged

in the real estate business in said state prior to the filing of the petition in bankruptcy on March 19, 1935. In the conduct of such business it purchased large tracts of unimproved land, subdivided portions of them into city lots, installed essential public improvements, and endeavored to sell said subdivided and improved lots, and did in fact sell a great many of them. It also acted as the selling agent for other parcels of land owned by third persons. It conducted its business for the purpose of making a profit. [R. 31.]

The properties and assets coming into the possession of petitioner consisted of numerous parcels of real estate, both improved and unimproved, accounts receivable, promissory notes, bills receivable, and other tangible personal property. Record legal title to approximately ninety per cent of the real property so received by the Trustee stood in the name of Security-First National Bank of Los Angeles in trust and as security for an indebtedness owing said bank by the bankrupt, all as evidenced by a written declaration of trust. The indebtedness of the bankrupt to said bank at the date of bankruptcy was in excess of $1,300,000.00. The bank filed a claim in the bankruptcy proceeding as an unsecured creditor in the amount of $500,000.00, after crediting what it believed to be the value of the security held by it. Other claims filed against the bankrupt estate exceeded $295,000.00, none of which have been paid by the petitioner either in whole or in part. [R. 32.]

For the purpose of avoiding a forced sale of the real properties covered by said trust and with the object of obtaining time within which to liquidate the properties at a fair value, a contract was made and entered into by and between the bank, the bankrupt and petitioner. A copy

of this contract, a supplement thereto and modifications thereof, is found in the record at pages 61 to 93, inclusive. This contract, supplement and modifications were approved by the Referee, the District Court and the Circuit Court of Appeals. (See *In re F. P. Newport Corporation, Ltd.*, 98 Fed. (2d) 453.)

This contract provided for the payment of the secured indebtedness of the bank in installments over a period of time and for the liquidation of the properties held by the bank as security for said indebtedness, upon terms and conditions satisfactory to the bankruptcy court. [R. 87.]

Among the properties title to which was so held by the said bank, were two parcels, one of three and the other of six acres, separated by an intervening three acre parcel belonging to third persons. During the pendency of the bankruptcy proceeding oil and gas wells were drilled and other wells were being drilled or about to be drilled on nearby lands which adjoined and surrounded said two parcels. It was feared by the Trustee and said bank that the operation of these wells would drain away the oil and gas believed by petitioner to underlie the same. Petitioner did not have sufficient funds to enable him to drill any oil or gas wells. By and with the approval of the Court he leased, on January 14, 1938, the two parcels of land to the Universal Consolidated Oil Company. Other lots in the same general area which were not of sufficient size to be covered by separate leases were included, with the approval of the court, in a community oil and gas lease wherein the Bankline Oil Company was lessee. [R. 33-34.]

The oil and gas lease to the Universal Consolidated Oil Company is contained in the record at pages 149 to 184, inclusive. By the terms of this lease the lessee was

granted the right to go upon the real property and prospect for oil and gas and other hydrocarbon substances, and to drill for, produce, extract, treat, remove and market oil, gas, natural gasoline and other hydrocarbon substances therefrom, and to maintain such tanks, boilers, houses, engines and other apparatus as might be necessary. The lessee was to pay to petitioner as Trustee in Bankruptcy a royalty of thirty-five per cent (35%) of the full market price of oil produced and saved, and a royalty of thirty-five per cent (35%) of the proceeds of the sale of gas or water. In addition thereto, a bonus was to be paid by the lessee of $25,000.00 in cash and $25,000.00 payable out of the first ten per cent (10%) of the gross production obtained from the demised premises. The lessee went upon the premises, drilled wells and extracted oil and gas, and paid to the Trustee during the year 1938 a cash bonus of $25,000.00, an oil bonus of $25,000.00, and oil and gas royalties of $195,517.65. [R. 37.] All of these monies were paid to the Security-First National Bank of Los Angeles by the petitioner upon orders of the Court to cover (a) taxes assessed against the properties, (b) costs of engineering services for checking oil and gas production, (c) interest on the indebtedness owing said bank, (d) to apply on principal owing said bank. [R. 34.]

In 1939 oil and gas royalties paid to the Trustee amounted to $206,333.36. These funds were likewise so paid to said bank to apply as above indicated. [R. 34.]

During the year 1938 petitioner, upon the approval of the bankruptcy court, sold a portion of the real properties of said estate for $5,500.00, and during 1939 properties of the estate were sold for a total of $19,450.00. All but twenty per cent (20%) of the amount so received was paid to said bank to apply on the indebtedness owing it;

the remaining twenty per cent (20%) was used by the Trustee to defray costs of sale and other expenses of administration.

Pending the sale of the real estate petitioner rented, mainly for agricultural purposes, portions of the real properties and received therefor during 1938 $6,350.48 and during 1939 $6,689.51. Other small collections were made by petitioner on account of the bankrupt's old accounts and from sales of miscellaneous personal properties. The total receipts of the Trustee from all sources were $259,578.93 in 1938 and $232,571.40 in 1939. After deductions allowed by the Commissioner of Internal Revnue the Commissioner determined that the net income for the year 1938 was $87,066.42 and for the year 1939 was $30,288.99. [R. 37-39.] Upon that alleged net income the tax in question was assessed.

Petitioner also granted easements and rights of way to the City of Los Angeles and the County of Los Angeles for street purposes, compromised with the approval of the Court certain claims made against the bankrupt, entered into agreements with the City of Long Beach concerning rights to oil and gas produced under the Universal Consolidated Oil Company lease hereinbefore mentioned pending determination of title disputes to the property covered by said lease, and made contracts with the Oilfield Testing & Engineering Company, Inc., for the checking of the oil and gas produced on the property. [R. 36.] The facts hereinbefore referred to were stipulated to, and the stipulation is found at pages 50 to 60, inclusive, of the record. The findings of fact of the Referee [R. 30-39] were in accordance with the stipulation of facts, so that the facts are without dispute, and are referred to in the opinion of the Circuit Court of Appeals. [R. 204-210.]

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on November 23, 1942. The jurisdiction of this Court is invoked under Judicial Code Section 240 (a), as amended by the Act of February 13, 1925, Chapter 229, 43 Stat. 938 (28 U. S. C. A. Section 347), and Section 24, subdivision (c) of the Bankruptcy Act.

Statute Involved.

The statute here involved is Section 52 of the Revenue Act of 1938, c. 289, 52 Stat. 447, reading as follows:

> "Sec. 52. Corporation Returns.
>
> "Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer, assistant treasurer, or chief accounting officer. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control."

Section 52(a) of the Internal Revenue Code (U. S. C. 1940 ed., Title 26, Sec. 52) is identical with the above quoted section.

Question Presented.

The sole question presented is whether or not petitioner is required to pay out of the assets of the bankrupt estate an "income tax" on the receipts had by him as such Trustee and resulting from the transactions hereinbefore mentioned.

Reasons Relied on for the Allowance of the Writ.

1. The Referee in Bankruptcy who initially passed upon the claim presented or filed by the Government held that the acts and transactions had and performed by petitioner were had, done and performed by him pursuant to the provisions of the Bankruptcy Act and in performance of his duties as such Trustee, and that in performing said acts and carrying out said transactions he was not operating the property or business of the bankrupt corporation within the meaning of the terms and provisions of said Section 52(a) of the Internal Revenue Code, and therefore was not required to pay any tax upon his said receipts.

The findings of the Referee were full and complete and were approved and affirmed by the District Court upon review. The Circuit Court of Appeals reversed the District Court, concluding that the acts and transactions of petitioner constituted "operating" the property within the meaning of the statute in question.

The conclusion of the Circuit Court of Appeals is in direct conflict with the decision of the Circuit Court of Appeals of the Second Circuit, in the *Matter of Heller,*

Hirsh & Co., Bankrupt, 258 Fed. 208 (43 A. B. R. 525) (1919), wherein the Circuit Court refers to the opinion of the Referee, which is in part as follows (page 211):

> "The language used in subdivision (c) shows that the subdivision was not intended by Congress to apply in the case of receivers or trustees in bankruptcy or assignees who merely marshaled and distributed the assets of an insolvent corporation among its creditors.
>
> "In terms subdivision (c) applies only in cases where receivers or trustees in bankruptcy or assignees 'are operating the property or business of corporations' and thus may be in the receipt of a 'net income' as defined in the prior sections of the Act. I regard the quoted words as of marked significance.
>
> "To my mind the subdivision was inserted in the Act to meet the specified case of the profitable operation of the business of a corporation by the officers mentioned; for instance, the operation of the business of a railroad corporation by receivers or the operation of the business of a manufacturing corporation by a trustee in bankruptcy, etc.
>
> "In either of such cases it is quite possible that the operation of the business might result in a net income, a result which Congress sought very properly to reach; see Scott v. Western Pacific R. R. Co., 246 Fed. 545, 548, 158 C. C. A. 515 (C. C. A. 9th Circuit, 1917). I repeat my conviction that in enacting subdivision (c) Congress had in mind the definite case so aptly described by the language used, and not the case of the officers mentioned when acting merely as liquidators."

2. In its decision the Circuit Court of Appeals has decided an important question of bankruptcy law which

has not been but should be settled by this Court. The decision of the Circuit Court of Appeals, if permitted to stand, will result in all trustees in bankruptcy being subjected to the payment of an income tax where they take possession of properties and pending their sale receive rentals for the use of any portion thereof or enter into any lease or contract for the production by another of oil or gas or other hydrocarbon substances from a parcel thereof, all of which is contrary to the intent and purpose of the statute in question, as it was not intended by this statute to subject a trustee to the payment of income tax upon receipts derived by him as the result of his performance of his duties as such trustee in marshaling, preserving and liquidating the assets of the estate.

A diligent search has been made, but petitioner has not found any decision of this Court construing the Act in question as applied to a trustee in bankruptcy.

Conclusion.

For the foregoing reasons it is respectfully submitted that this Petition should be granted.

H. F. METCALF,

As Trustee in Bankruptcy of F. P. Newport Corporation, Ltd., a Corporation, Bankrupt, Petitioner.

NORMAN A. BAILIE,

RICHARD A. TURNER,
Counsel for Petitioner.

ALLEN T. LYNCH,
Of Counsel.

IN THE

Supreme Court of the United States

October Term, 1942.

No. .....

H. F. METCALF, as Trustee in Bankruptcy of the Estate of F. P. NEWPORT CORPORATION, LTD., a corporation, Bankrupt,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

Decisions of the Courts Below.

As hereinbefore noted in the Petition, the Referee in Bankruptcy disallowed the claim of the United States of America, and the Referee's findings and order appear in the record. [R. 28-41.] A review was taken by the Government, and the District Court affirmed without opinion the order of the Referee. [R. 188-189.]

The opinion of the Circuit Court of Appeals reversing the District Court appears in the record. [R. 204-210.] (..... Fed. (2d) .....)

II.

Jurisdiction.

The jurisdictional statement appears in the preceding Petition for Writ of Certiorari (*supra*, p. 7).

III.

Statement.

The essential facts are stated in the preceding Petition for Writ of Certiorari (*supra*, pp. 2-6).

IV.

Specifications of Error.

1. The Circuit Court of Appeals erred in holding that the Trustee in Bankruptcy was during the years 1938 and 1939 "operating" the property of the bankrupt corporation within the meaning of Section 52 of the Revenue Act of 1938, Chapter 289.

2. The Circuit Court of Appeals erred in reversing the decision of the District Court.

V.

Summary of Argument.

A. The decision of the Circuit Court of Appeals is in conflict with the decision of the Second Circuit Court of Appeals in *In re Heller, Hirsh & Co., Bankrupt*, 258 Fed. 208.

B. The Circuit Court of Appeals has decided an important question of Federal law which has not been but should be settled by this Court.

VI.
ARGUMENT.

A. The Decision of the Circuit Court of Appeals Is in Conflict With the Decision of the Second Circuit Court of Appeals in In re Heller, Hirsh & Co., 258 Fed. 208.

The decision of the Circuit Court of Appeals in the instant case is contrary to and in conflict with the decision of the Second Circuit Court of Appeals in the above mentioned case.

In the *Heller, Hirsh & Co.* case, the Government sought to obtain payment of an income tax on funds collected by the trustee as a result of a compromise made by him with a foreign corporation of a claim for nonpayment of salary and commissions by that corporation to the bankrupt corporation between the years 1910 and 1914. The Court held that this clearly did not constitute net income earned by a trustee while operating the business of the bankrupt corporation, and refers to the decision of the referee who decided the case initially. The decision of the referee reads in part as follows (page 210-211):

> " 'I find nothing in the act of September 8, 1916, to indicate that Congress intended to impose an income tax upon a trustee in bankruptcy in respect to the assets of a bankrupt corporation which he has taken over to be marshaled and distributed among the creditors of the corporation. To my mind the text of the act of September 8, 1916, does not indicate any such purpose. This view of the act does not deprive the government of its just due. The dividends declared and distributed to the creditors are presumptively income in the hands of the latter subject to an income tax to be assessed against the latter.

" 'Part I of the act of September 8, 1916 (Comp. St. §§ 6336a-6336iii), deals with the income tax on individuals: Section 1 (Comp. St. § 6336a) provides for a tax on "the entire net income" of the individual. Section 5 and section 6 (Comp. St. §§ 6336e, 6336f) provide for certain deductions before the amount of the "net income" is determined. Sections 2(b) and 8(c) (Comp. St. §§ 6336b, 6336h) contemplate cases where the corpus of the individual's property (both after his death or during his lifetime) is in the possession of and the income received by persons acting in a fiduciary capacity.

" 'There is not the slightest suggestion in part I of the statute either that Congress intended to impose an income tax upon an insolvent individual liquidating his own estate or upon the liquidator of an insolvent individual's estate, nor is there any suggestion that it entered into the mind of Congress that such insolvent individual or his liquidator should be regarded as having a "net income."

" 'Such being my conclusion with respect to individuals dealt with in part I of the act, I pass to part II of the act (Comp. St. §§ 6336j-6336n), dealing with the income tax on corporations. I find nothing in part II to indicate that Congress intended to apply a different rule in the case of corporations from that enacted in the case of individuals. Section 10 (Comp. St. § 6336j) imposes an income tax upon the "total net income" received by a corporation. Section 12(a), being section 63361, Comp. St., provides for certain deductions before such "net income" is ascertained.

" 'Great stress is laid by the government on the provisions of section 13(c) of the act of September

8, 1916. The presence of subdivision (c) in the act of September 8, 1916, and its absence from the prior act of October 3, 1913, has to my mind no significance in the present case in view of the peculiar language of subdivision (c).

" 'The language used in subdivision (c) shows that the subdivision was not intended by Congress to apply in the case of receivers or trustees in bankruptcy or assignees who merely marshaled and distributed the assets of an insolvent corporation among its creditors. In terms subdivision (c) applies only in cases where receivers or trustees in bankruptcy or assignees "are operating the property or business of corporations" and thus may be in the receipt of a "net income" as defined in the prior sections of the act. I regard the quoted words as of marked significance.

" 'To my mind the subdivision was inserted in the act to meet the specified case of the profitable operation of the business of a corporation by the officers mentioned; for instance, the operation of the business of a railroad corporation by receivers or the operation of the business of a manufacturing corporation by a trustee in bankruptcy, etc.

" 'In either of such cases it is quite possible that the operation of the business might result in a net income, a result which Congress sought very properly to reach. See Scott v. Western Pacific R. R. Co., 246 Fed. 545, 548, 158 C. C. A. 515 (C. C. A. 9th Circuit, 1917). I repeat my conviction that in enacting subdivision (c) Congress had in mind the definite case so aptly described by the language used, and not the case of the officers mentioned when acting merely as liquidators.

" 'The decisions rendered in this circuit, where receivers were engaged in operating the business of street railroad corporations, give some support to the view I have expressd, although the cases arose under the so-called United States Corporation Tax Law of August 5, 1909, c. 6, 36 Stat. 112, and not under the Income Tax Acts of October 3, 1913, or September 8, 1916.

" 'It has been held that the Corporation Tax Law of 1909 imposed an excise tax upon the business of a corporation in a sum equivalent to 1 per cent. upon the "entire net income" of a corporation above $5,000. It is to be noted that whether the tax imposed be termed an excise tax or a direct income tax, its imposition depended upon the existence of a "net income."

" 'The United States district attorney applied to the Circuit Court to compel the receivers of the Metropolitan Street Railway Company and the receiver of the Third Avenue Railroad Company to file returns for those corporations for the years 1909 and 1910.

" 'The Circuit Judge (Pennsylvania Steel Co. v. New York City Railway Co. (D. C.), 193 Fed. 286) held (bottom of page 287) that the statute was not intended to impose a tax upon the income realized from the assets of a bankrupt corporation whose property had been taken over by a court through its officers to be marshaled and distributed and that the language used did not indicate any such intent.

" 'This ruling, denying the application of the United States district attorney against the receivers, was affirmed by the Circuit Court of Appeals, 198 Fed. 774, 117 C. C. A. 556. The opinion states that

such statutes are to be strictly construed, and that the act of 1909 (198 Fed. 775-777, 117 C. C. A. 557-559) manifested no intent to impose a tax except where a corporation is carrying on business, and not where it is insolvent and in the hands of receivers.

"'The decision of the Circuit Court of Appeals was affirmed by the United States Supreme Court (United States v. Whitridge, 231 U. S. 144, 149, 34 Sup. Ct. 24, 25, 58 L. Ed. 159), the court holding that receivers of insolvent corporations were not within "the spirit" or "the letter" of the act. Attention is also called to the recent decision by Hotchkiss, J., in Lathers v. Hamlin, 102 Misc. Rep. 563, 170 N. Y. Supp. 98.'"

From the foregoing it is observed that prior to 1916 no tax was imposed upon a trustee in bankruptcy regardless of the nature of his transactions. (See also *Reinecke v. Gardner* (1928), 72 L. Ed. 866, at p. 867 [277 U. S. 239].) In 1916 the predecessor of the present Act was passed, its object being to reach "income" of a trustee only in the limited case where he was "operating the property or business of corporations." The Act must be construed most strongly against the Government and in favor of the alleged taxpayer. (See *Gould v. Gould* (1917), 62 L. Ed. 211 [245 U. S. 149].)

The business referred to in Section 52 of the Internal Revenue Act here in question is the business theretofore conducted by the bankrupt corporation. Prior to bankruptcy the business of the bankrupt corporation was that of buying, subdividing, improving and selling real estate, and acting as a broker or selling agent for properties owned by third persons. [R. 31.] This business was not carried on by the Trustee. The transactions of the

Trustee in the instant cause consisted of marshaling, preserving and liquidating the properties of the bankrupt corporation as rapidly as was compatible with the best interests of the parties concerned. The functions so exercised by him, however, were not intended to be nor were they in fact in furtherance of the business theretofore carried on by the bankrupt corporation, but were those normally imposed upon every trustee in bankruptcy by the express provisions of the Bankruptcy Act.

Section 47 of the Bankruptcy Act reads in part as follows:

> "Trustees shall (1) collect and reduce to money the property of the estates for which they are trustees, under the direction of the court, and close up the estates as expeditiously as is compatible with the best interests of the parties in interest."

Congress is presumed to have in mind the provisions of the Bankruptcy Act when it passed Section 52 of the Internal Revenue Law here in question. Had it intended to reach all transactions had by a trustee, it would have provided that the trustee would be liable for the payment of an income tax the same as a corporation in all instances. By limiting the imposition of the tax to those instances where the trustee was operating the business or property of the bankrupt corporation, it intended to confine the impact of the statute to those instances where the trustee was operating the business or property of the bankrupt corporation in the usual significance or application of those terms. It is obvious that the business of the bankrupt corporation was not operated by the Trustee. This leaves for consideration the phrase "operating the property."

To operate the property Congress necessarily refers to its actual use in the business or employment for which it has been contracted or acquired, and with the object or purpose of making a profit. Judge Yankwich of the District Court of the United States, District of Nevada, speaking in the case of *In re Owl Drug Co.* (1937), 21 Fed. Supp. 907, says at pages 909-910:

> "However, section 52 of the Revenue Act of 1934 (26 U. S. C. A. § 52) provided, in part: 'Every corporation subject to taxation under this title (chapter) shall make a return. * * * *In cases where* receivers, *trustees in bankruptcy,* or assignees *are operating the property or business of corporations, such* receivers, *trustees,* or assignees *shall make returns for such corporations in the same manner and form as corporations are required to make returns.* Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.' (Italics added.) Thus, while *every* corporation subject to taxation must make a return, the return is required of receivers, trustees in bankruptcy, and assignees of corporations, *only when they are operating the property or business of the corporation.* The effect of an enactment of this character is stated in Paul & Mertens, op. cit., § 39.29: 'Receivers, trustees in bankruptcy, and assignees *operating the property or business of corporations* are required to file returns in the same manner and form as corporations are required to make returns. *Whether or not there is such operation is determined by the facts in the particular case.* The statute and regulations make a distinction between receivers operating *all* the property or business of an individual or corporation, and

receivers in possession of only part of such property or business. The former type of receiver is required to file a return, the latter is not.' And thus the Board of Tax Appeals: 'The effect of this section is that receivers, trustees in bankruptcy or assignees *who are operating the property or business of corporations* "shall make returns for such corporations."' Trustees of Gonzolus Creek Oil Co. (Dissolved), 12 B. T. A. 310, 322.

"The return is obligatory when the trustee *continues* the bankrupt's business. 'Where receivers or *trustees continue the business* of a bankrupt any income thus earned is taxable under the various federal income tax laws. *But where they merely marshal and distribute the assets of the insolvent, there is no income, and hence no income tax is payable.*' 6 Remington on Bankruptcy (1923), § 2978. (Italics added.) And see Gilbert's Collier on Bankruptcy (4th Ed. (1937) § 1297).

"The trustee must operate all the property of the bankrupt. Burnet v. North American Oil Consol. (C. C. A.), 50 F. (2d) 752; Trojan Oil Co. (1932), 26 B. T. A. 659; Commissioner v. Owens (C. C. A. 10, 1935), 78 F. (2d) 768. When he does, the income is, in truth, that of the corporation. He makes the return 'for the corporation.' However, as under the Bankruptcy Act the property of the bankrupt vests in the trustee, the Supreme Court has held that the income is not the income of the bankrupt corporation, but *'of the trustee, and was subject to income and excess profits tax only if the statutes authorized the assessment of the tax against him.'* Reinecke v. Gardner (1928), 277 U. S. 239, 241, 48 S. Ct. 472, 473, 72 L. Ed. 866. (Italics added.)

"Prior to 1916, no such provision existed in the revenue acts. And courts, on the basis of the principle stated, in Reinecke v. Gardner, *supra*, held uniformly that receivers operating the property of corporations were not subject to this tax. See Pennsylvania Steel Co. v. New York City Ry. Co. (C. C. A. 2, 1912), 198 F. 774; Scott v. Western Pacific Ry. Co. (C. C. A. 9, 1917), 246 F. 545; United States v. Whitridge (1913), 231 U. S. 144, 34 S. Ct. 24, 58 L. Ed. 159.

"Since 1916 (39 Stat. 756) the yearly revenue acts have contained provisions identical with the one under consideration. Their object is to reach a new source of income taxation, not reached before. But income from that source is not available, unless all the conditions imposed by the section coexist. The most fundamental one is that the receiver, trustee in bankruptcy, or assignee must be 'operating the property or business' of a corporation, and all of it.

"To 'operate' means *to put into, or to continue in operation or activity, to manage, to conduct, to carry out or through.* This is both the ordinary and the legal definition of the word. See Webster's New International Dictionary; 6 Words and Phrases, First Series (1904) pp. 4989 *et seq.*; 3 Words and Phrases, Second Series (1914) pp. 743 *et seq.*; 5 Words and Phrases, Third Series (1929) pp. 629 *et seq.*; 2 Words and Phrases, Fourth Series (1933) pp. 864 *et seq.* The new Shorter Oxford English Dictionary defines it as follows: 'To direct the working of, to manage, *conduct, work* (a railway, business, etc.); to carry out, direct to an end (an undertaking, etc.); chiefly U. S. 1880.' Volume II, p. 1374.

"The operation of a business implies its conduct and management not sporadically, but continuously over a definite period of time, with one aim—*profit making*. Repeatedly, when deductions have been claimed by a taxpayer for losses resulting from the claimed 'operation' of a trade or business during the taxable year, under the provisions of the various revenue statutes, allowing such deductions, the courts have held that the requirement of continuity and assiduity had to be satisfied. See Bedell v. Commissioner of Internal Revenue (C. C. A. 2, 1929), 30 F. (2d) 622; Schuette v. Anderson (C. C. A. 2, 1932), 55 F. (2d) 902. And see State of Iowa *ex rel.* Ben J. Gibson, Atty. Gen., Plaintiff, v. American Bonding & Casualty Co., Defendant, United States of America, Claimant (D. C. Iowa, in and for Woodbury County, Sept. 15, 1936, opinion by A. O. Wakefield, Judge, not reported).

"The business of a corporation is 'that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.' Flint v. Stone Tracy Co. (1911), 220 U. S. 107, 171, 31 S. Ct. 342, 357, 55 L. Ed. 389, Ann. Cas. 1912B, 1312."

As pointed out by Judge Yankwich in the foregoing decision, "to 'operate' means to put into, or to continue in operation or activity, to manage, to conduct, to carry out or through." Therefore to operate a property means to conduct or manage that property for the purpose for which it was acquired or contracted, such as the operation of a railroad, the operation of a store or mercantile establishment. In that sense the property or corpus of this bankrupt estate which came into the possession of the Trustee was never operated. It is true that in exer-

cising the functions required of him by the Bankruptcy Act he took possession of the property. He discovered after so acquiring possession that oil was being developed on properties adjacent to a portion of the corpus of this estate. This fact led him to the conclusion that oil underlay this property. *Oil and gas which did underlie the property would be an asset if it could be captured and reduced to possession.* He had no money with which to undertake necessary drilling operations. With the approval, therefore, of the bankruptcy court, he leased the property to the Universal Consolidated Oil Company in order that that company might go upon the property, drill the same and produce such oil and gas and other hydrocarbon substances as might be captured. The operations necessary in drilling the wells and capturing and reducing to possession the oil and gas and other hydrocarbon substances that might underlie the same were performed by the lessee. The lessee paid for the exclusive privilege of going upon the property and drilling for and producing such oil and gas as might be found thereunder, a cash bonus of $25,000 and an additional $25,000 bonus payable out of the proceeds of oil. The lessee was not the agent of the Trustee but an independent contractor, who, for a consideration paid to the Trustee with the approval of the bankruptcy court, acquired the exclusive right to carry on the drilling operations and produce such oil and gas as might as a result thereof be discovered. When produced all but thirty-five per cent thereof was the lessee's property, for which it had paid in cash and services. Thirty-five per cent thereof belonged to the Trustee. This was sold at market and the proceeds paid to the Trustee. Thus an asset was reduced to cash and distributed to a creditor. The result was that the Trustee received dur-

ing the tax years in question, to-wit, 1938 and 1939, a total of $451,851.01 from oil royalties and bonuses. His total receipts for the two years in question amounted to $492,150.33, so that the oil royalties and bonuses accounted for all but $40,299.32 of his total receipts. [R. 37-38.] Under the terms of the lease the Trustee reserved the right to take a portion of the oil in kind. That was a right, however, which was never exercised, and the Trustee has only received payment in cash.

It should be observed that the bankrupt corporation at no time was engaged in the business of acquiring and developing oil wells, or in the business of drilling for or producing oil and gas. It seems clear that the negotiations for and the execution of the lease and the receipt of the cash payments from the lessee did not constitute an operation of the property by the Trustee, but on the contrary was the method adopted for the liquidation and the reduction to cash of an asset which existed only if it could be captured and reduced to possession. That process of capturing and reducing to possession was carried on by an independent contractor and as result thereof the Trustee acquired cash which was distributed pursuant to the orders of the bankruptcy court to a secured creditor to apply on the indebtedness owing it, and to pay taxes assessed against the property.

Sales of real and personal properties during the two years in question accounted for $25,048.53 of the monies received by the Trustee. [R.37-38.] Obviously this was a mere liquidation and the monies were the result of a liquidation, yet the Government attempts to tax the Trustee during 1938 on the amount that the selling price exceeded the original cost to the bankrupt corporation of the property sold. As a result, in every case where a trustee sells

an asset of the bankrupt estate he must pay a tax if he is fortunate enough to sell the same at a price greater than the cost to the bankrupt of the property sold. It seems clear that such a result was never contemplated by Congress, and that the Circuit Court in sanctioning such a tax has given the statute in question a much broader scope and effect than was intended by Congress.

Collections of principal and interest on the bankrupt corporation's accounts receivable amounted to $2,210.80 during the years in question. [R. 37.] Such collections represent the proceeds of a liquidation of receivables which were a part of the assets passing to the Trustee upon his appointment and qualification, and again the receipts resulting therefrom were not acquired as the result of the operation of the business of the bankrupt corporation.

Pending liquidation thereof, the Trustee rented certain of the properties and received as compensation therefor a total of $13,039.99 during the years in question, all of which was absorbed in payment of expenses of administration, including cost of preserving the properties concerned. [R. 37-39.] The rental value of the property so let was an asset which the Trustee was required to preserve for the benefit of the estate until he could sell the property. The collection of such rentals was temporary and only an incident in the process of liquidation.

The above mentioned transactions account for all of the receipts of the Trustee during the two years in question, and at the risk of repetition, we repeat that these transactions by the Trustee were had pursuant to an exercise of his normal duties as Trustee, and did not constitute an operation of the business or property of the corporation within the meaning of Section 52 of the Internal Revenue

law, and the decision of the Circuit Court of Appeals in reversing the District Court and holding that they did amount to an operation of the business or property of the corporation is directly contrary to the case of *In re Heller, Hirsh & Co.*, and particularly the opinion of the referee which was referred to by the Circuit Court in deciding the *Heller, Hirsh & Co.* case.

B. The Circuit Court of Appeals Has Decided an Important Question of Federal Law Which Has Not Been but Should Be Settled by This Court.

The decision of the Circuit Court of Appeals is concerned wholly with a construction of Section 52 of the Revenue Act of 1938 and its application to the facts found by the referee in bankruptcy. These facts are without dispute.

A careful and diligent search has been made, but no decision of this Court can be found which involves a construction of this Act as applied to a trustee in bankruptcy. This decision vitally affects the administration of all bankrupt estates and the future administration of the estate here involved. It is particularly important that this Court settle the issue and determine the answer to the following:

(a) Must the trustee pay an income tax on receipts resulting from a liquidation of assets where in the interest of the parties concerned the liquidation process is extended over a period of time?

(b) Where real property of a corporation not theretofore engaged in the oil business passes to a trustee in bankruptcy and he leases the same for the production of such oil and gas as may be found thereunder and receives a bonus for the lease and royalties on oil and gas produced,

is he by virtue of such lease operating the property of the corporation and subject to the payment of an income tax on monies paid to him under such lease?

(c) If one transaction had by the trustee constitutes operating the property of the bankrupt, does this subject him to a tax on all his receipts or only those resulting from the particular transaction?

An answer by this Court to the foregoing queries will be of inestimable value to the administration of all bankrupt estates, for if the liquidation of assets may result in a tax, no distribution can be had in any estate until it is first determined whether or not the transactions had by the trustee in the process of such liquidation subject him to the payment of a tax.

Thus if a bankrupt corporation engaged in the stock and bond business has among its assets at the time of the appointment and qualification of the trustee an orange grove, is the trustee who then acquires title operating the property of the corporation within the meaning of the statute in question, if pending a sale of the grove he causes necessary irrigation to be performed, and harvests and sells the fruit? If that transaction amounts to an operation of the property, is he liable for tax only on receipts from the grove, or must he pay on all receipts, even though the balance of those receipts were the result of sales of securities and collections of the bankrupt's accounts receivable.

It is at once apparent that the problems facing the administration of bankrupt estates are as a result of the decision of the Circuit Court of Appeals multiplied many times, and that a decision by this Court of the issue here

involved will be of inestimable value and aid in the administration of all such estates. The decisions cited by the Circuit Court of Appeals in its decision which involve a construction of the Act, have to do with transactions had by an equity receiver, and do not involve transactions had by a trustee in bankruptcy. The regulations adopted by the Treasury Department clearly recognize the distinction between a trustee in bankruptcy and a receiver. Treasury Regulation 101, promulgated under the Revenue Act of 1938, reads as follows:

> "ART. 52-2. Returns by receivers.—Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilites which would devolve upon the officers of the corporation were they in control. (See sections 274 and 298 and articles 274-1 and 274-2.) A receiver in charge

of only part of the property of a corporation, however, as, for example, a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income."

It will be observed that a receiver in control of all of the business and property of a corporation is deemed by the regulations to be operating the business or property even though he be engaged only in marshaling, selling and disposing of the assets. Apparently the distinction is a result of a recognition of the fact that a receiver has no title; that he operates as an officer of the court in liquidating the property, which nevertheless remains the property of the corporation. The general rule applicable to income tax is that liability therefore attaches to the ownership of the income. (*Blair v. Commissioner of Internal Revenue,* (1937), 81 L. Ed. 465 at 470 [300 U. S. 5].) A receiver is not the owner of the income but merely a custodian. (See *Commissioner of Internal Revenue v. Owens,* 78 Fed. (2d) 768; *North American Oil Consolidated v. Burnet* (1932), 76 L. Ed. 1197 [286 U. S. 417].)

A trustee acquires title and the property is no longer that of the corporation, and necessarily if there is an income as a result of his transactions it is his income and in no sense that of the corporation.

Since the decision of the Circuit Court of Appeals involves a construction of Federal law and the issue is one of national importance, we respectfully urge that it presents a situation wherein this Court should in view of Rule 38, Section 5, Subdivision (b), grant the writ.

Conclusion.

It is respectfully urged that for the reasons hereinbefore stated the Petition should be granted, and a Writ of Certiorari issued to the Circuit Court of Appeals of the Ninth Circuit for the purpose of reviewing the decision in question.

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RICHARD A. TURNER,
Counsel for Petitioner.

Of Counsel:
ALLEN T. LYNCH.

INDEX

CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 665

H. F. METCALF, AS TRUSTEE IN BANKRUPTCY OF THE ESTATE OF F. P. NEWPORT CORPORATION, LTD., A CORPORATION, BANKRUPT, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The District Court rendered no opinion, but adopted as its findings of fact and conclusions of law the findings and conclusions of the referee in bankruptcy (R. 188–189). The latter may be found at R. 28–41. The opinion of the Circuit Court of Appeals (R. 204–210) is reported at 131 F. 2d 677.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered November 23, 1942 (R. 211). The

petition for a writ of certiorari was filed on January 20, 1943. Jurisdiction is conferred on this Court under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the trustee in bankruptcy of a corporation engaged in the business of buying and selling real property for profit, who took over the bankrupt's assets, entered upon a program of selling the properties over a period of time, made repairs and improvements, and executed oil and gas leases was "operating the property or business" within the meaning of Section 52 of the Revenue Act of 1938 and Section 52 (a) of the Internal Revenue Code and therefore subject to income tax upon the net income derived from such activities.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447, provides:

> SEC. 52. CORPORATION RETURNS.
>
> Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe. The return shall

> be sworn to by the president, vice president, or other principal officer and by the treasurer, assistant treasurer, or chief accounting officer. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

Section 52 (a) of the Internal Revenue Code (U. S. C. Title 26, Sec. 52) is identical with this provision.

Treasury Regulations 101 promulgated under the Revenue Act of 1938 provides:

> ART. 52–2. *Returns by receivers.*—Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations. If a receiver has full custody of and control over the business or property of a corporation, he shall be deemed to be operating such business or property within the meaning of section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshaling, selling, and disposing of its

> assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. (See sections 274 and 298 and articles 274–1 and 274–2.) A receiver in charge of only part of the property of a corporation, however, as, for example, a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income.

Section 19.52–2 of Treasury Regulations 103, promulgated under the Internal Revenue Code, is identical with this provision.

STATEMENT

The facts were stipulated (R. 50–60). The findings of the referee, which were adopted by the District Court, may be summarized as follows:

The F. P. Newport Corporation, Ltd., a Delaware corporation organized in 1929, conducted a real-estate business in California (R. 31). On January 12, 1937, it was adjudicated a bankrupt, and on March 18, 1937, H. F. Metcalf was appointed trustee. Since that date the trustee has

had possession and control of all the bankrupt's property and assets, consisting of numerous parcels of improved and unimproved real estate, accounts, promissory notes, bills receivable, and other tangible and intangible property. (R. 31–32.)

Prior to the filing of the petition in bankruptcy, approximately 90 per cent of the company's real estate was encumbered by a deed of trust in favor of the Security-First National Bank of Los Angeles, to secure an indebtedness in excess of $1,300,000 (R. 32). An agreement was reached between the trustee and the bank, with the approval of the District Court, authorizing the trustee to sell the property covered by the deed of trust and to collect rents and income from the properties (R. 32–33, Stip. Ex. A, R. 61). Amounts received by the trustee were to be applied to taxes and upkeep expenses, and the balance was to be used to pay the principal and interest on the loan (R. 69–70). All sales made by the trustee were duly approved by order of the court. Pending sale, some of the properties were rented by the trustee mainly for agricultural purposes. Repairs were made upon certain properties, and improvements were made upon others to preserve them from the hazards of fire and flood. (R. 35.)

Among the real properties of the bankrupt which are located in the City of Long Beach, California, and title to which is held by the bank under the declaration of trust, are two parcels—one of three and the other of six acres, separated

by an intervening three-acre parcel belonging to third persons (R. 33). During the pendency of the bankruptcy proceeding, producing oil and gas wells were drilled and other wells were being drilled or about to be drilled on nearby lands which adjoined the two parcels (R. 33). Both the trustee and the Bank feared that the operation of these wells would drain away the oil and gas believed to underlie the bankrupt's land (R. 33). Since the trustee did not have sufficient funds to enable him to drill any oil or gas wells, he leased the two parcels of land to Universal Consolidated Oil Company after securing the approval of the court for the transaction (R. 33). Other lots in the same general area which were not of sufficient size to be covered by separate leases were included in a community oil and gas lease wherein the Bankline Oil Company was the lessee (R. 34).

Oil and gas royalties including bonuses actually paid to the trustee under the terms and provisions of the leases amounted to $245,517.65 during the year 1938, and $206,333.36 during the year 1939 (R. 34). Upon orders of the court, these moneys were paid by the trustee to the bank to cover taxes assessed against the properties, costs of engineering services for checking oil and gas production on the leased property, and interest and principal owing to the bank (R. 34).

While no general order of the court was made authorizing the trustee to conduct the business of

the bankrupt corporation, several specific orders were made authorizing the conduct of business activities. Thus, in addition to negotiation of the oil leases, the trustee was authorized by the court to renew contracts with the Oil Field Testing and Engineering Company, Inc., for checking oil and gas production on that property, to lease (pending sale) a building belonging to the bankrupt estate for the storage of hay, to lease (pending sale) certain unsubdivided lands, to grant easements and rights-of-way to the City of Los Angeles and County of Los Angeles for street purposes, and to enter into agreements with the City of Long Beach concerning rights to oil and gas produced under the above-mentioned Universal Consolidated Oil Company lease pending determination of title disputes to the property covered by the lease. (R. 36.)

In the two tax years, only $24,950 of a total of $492,150.33 in receipts came from the sale of real estate. Over $451,850 came from leasing the oil properties. Other income came from leasing miscellaneous properties. (R. 37–39.)

The referee's findings of fact, and his conclusion of law that the trustee was not operating the property or business of the bankrupt corporation within the meaning of Section 52 of the Revenue Act of 1938 and Section 52 (a) of the Internal Revenue Code, were adopted by the District Court (R. 28–41, 188–189).

The court below reversed the District Court, holding that on the facts as above stated the trustee was operating the property and business of the bankrupt within the meaning of Section 52 (R. 211).

ARGUMENT

The evident purpose of Congress in enacting Section 52 of the income tax statute was to extend the general income tax imposed on corporations to the theretofore untaxed income received by receivers, trustees in bankruptcy, or assignees, when they are engaged in operating the business or property of which they have custody or control. See *Reinecke* v. *Gardner*, 277 U. S. 239; *United States* v. *Chicago & E. I. Ry. Co.*, 298 Fed. 779 (N. D. Ill.). This broad purpose would not be fostered by a restrictive construction of the phrase "operating the property or business." The facts of the instant case show clearly that the petitioner was "operating the property or business" of the corporation within the meaning and purpose of the statute.

The decision of the court below that petitioner was thus "operating the property or business" of the bankrupt turns entirely upon the application of standard legal principles to the peculiar facts of this case. *In re Heller, Hirsh & Co.*, 258 Fed. 208 (C. C. A. 2), is not in conflict with this decision, since in that case the trustee in bankruptcy did nothing more than collect the proceeds of a

claim which he compromised and which arose under a contract entered into and completely executed by the corporation prior to the bankruptcy. Nor is *In re Owl Drug Co.*, 21 F. Supp. 907 (Nev.), relevant here, since that case involved only the taxability of the interest earned on the proceeds realized from the liquidation of the business.

CONCLUSION

The decision of the court below is correct. It presents no conflict or question of general importance which would warrant further review by this Court. We respectfully submit that the petition should be denied.

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